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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

THE EL PASO COMPANY,
Petitioner,

v.

UNITED STATES OF AMERICA, *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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BRIEF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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INTEREST OF AMICUS CURIAE

With the consent of all the parties, the National Association of Manufacturers (NAM) files this brief in support of the Petitioner. The NAM is a non-profit voluntary business association incorporated under the laws of the State of New York NAM has a membership of approximately 12,000 manufacturing and related business concerns which, in the aggregate, produce an estimated 80 percent of all goods manufactured in the United States.

As for-profit corporations, all of NAM's corporate members file tax returns and are, therefore, subject to periodic audit by the Internal Revenue Service (IRS). Members of the NAM try to cooperate with the IRS in these audits and are usually willing to provide all requested information that is relevant to the IRS audit. In addition, since many NAM members are publicly held entities, they are also subject to the various rules and regulations, as well as the statutes, administered and enforced by the Securities and Exchange Commission (SEC).

NAM members, like most corporations and many individuals, employ or retain professionals with expertise in a variety of fields for the purpose of assuring compliance with these complex laws. In the case at bar, in-house counsel directed and assisted in the preparation of the Petitioner's tax pool analysis, from which certain data were discussed with its retained independent auditors who, in turn, reviewed Petitioner's financial statements as required by the SEC. Despite the fact that this analysis was neither prepared for nor used in connection with the preparation of Petitioner's tax return, the court deemed this information to be "relevant" within the meaning of 26 U.S.C. § 7602. Furthermore, Petitioner's limited discussion of certain data relating to this analysis with the independent auditors led the court below to determine that the attorney-client privilege was waived as to the entire tax pool analysis being requested by the IRS in connection with the tax audit.

The weakening of the relevancy requirement of § 7602 and the erosion of the attorney-client privilege that the decision of the court below has caused are serious issues that deserve the scrutiny of this Court. Further, the fact that the holding below allows the IRS to freely review virtually any corporate document, regardless of its pertinence to a tax return, with little more than a bald assertion that it might "throw light" on the return, creates

the potential for a great deal of mischief and unwarranted "fishing expeditions" through corporate files.

The potential breadth of this decision in its impact throughout American industry and the fact that it penalizes good faith corporate efforts to comply with complex federal laws with an involuntary waiver of the attorney-client privilege could have a profound effect on the membership of the NAM. Offering this broad base of representation, we believe that we can present this Court with a perspective beyond that which is represented by the Petitioner.

SUMMARY OF THE CASE

On February 13, 1980, the IRS issued a summons pursuant to 26 U.S.C. § 7602 to the Petitioner, The El Paso Company, in connection with a routine examination of the company's tax returns for the years 1976 through 1978. Among other things, the summons requested the production of documents, memoranda, letters, or work papers which identified and discussed potential tax liabilities or tax problems for the period beginning January 1, 1976 through December 31, 1978. The principal purpose of the summons was to obtain El Paso's tax pool analysis even though the analysis was not used in El Paso's preparation of its tax returns for the years in question.

The Petitioner declined to comply with the summons on the grounds that the documents sought were not relevant or material to any legitimate IRS inquiry and that they were, in any case, privileged. On May 27, 1981, the IRS filed a petition for the enforcement of its summons in the United States District Court for the Southern District of Texas. El Paso maintained that the summons was overbroad, that the documents were not relevant to any legitimate investigatory purpose of the IRS, and that they were protected by the attorney-client and/or

work-product privileges. The District Court rejected these contentions, adopting instead the findings of fact and conclusions of law prepared by the government without change.

A divided Court of Appeals for the Fifth Circuit affirmed the judgment of the District Court on August 13, 1982. While narrowing the permissible scope of the summons somewhat, the appellate court held that the tax pool analysis was "relevant" within the meaning of 26 U.S.C. § 7602, despite a contrary holding by the Tenth Circuit in *United States v. Coopers and Lybrand*, 550 F.2d 615 (10th Cir. 1977). The court concluded that this material might be useful to the IRS as a "road map" through El Paso's tax returns.

The Court of Appeals also refused to classify the tax pool analysis as privileged information since it was not, in its judgment, prepared in anticipation of litigation and since certain items contained therein were discussed with the Petitioner's independent auditors.[1]

SUMMARY OF THE ARGUMENT

The decision of the court below underscores and widens a split among the circuits as to the quantum of evidence the IRS must produce in order to demonstrate that a piece of information is "relevant" to a tax audit and therefore subject to examination pursuant to 26 U.S.C. § 7602. The guidance of this Court is required to give substance to the relevancy requirements it enunciated in *United States v. Powell*, 379 U.S. 48 (1964).

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[1] The court did acknowledge that this portion of its holding was at variance with a decision rendered by the Second Circuit in *United States v. Arthur Young and Co.*, 677 F.2d 211 (2d Cir. 1982), *petition for cert. filed*, No. 82-687 (Oct. 20, 1982). This issue is fully discussed in El Paso's petition at 14-16, 18-21.

This decision penalizes the Petitioner, and potentially other similarly situated corporations, for their efforts to comply with a variety of complex federal laws. In this case, the Petitioner's attorneys directed the preparation of a tax pool analysis analyzing the possibility of future potential tax liabilities and any litigation or negotiation that might occur with the IRS over same. The preparation of a tax pool analysis is common in publicly held corporations. This material was not used in the preparation of the tax returns that were the subject of the tax audit here. The drafting and preparation of the financial statements required by the SEC mandate that the independent auditors of the Petitioner receive certain information that is contained in the tax pool analysis. Such information was received in discussions with the Petitioner's counsel, but at no time were the tax pool analysis documents ever shown to the independent auditors. This process, required both by generally accepted accounting principles and SEC regulations, led the court below to declare that the Petitioners had, in effect, waived the attorney-client privilege as to all documents contained in the tax pool analysis despite contrary lines of authority in other circuits. *United States v. Upjohn*, 600 F.2d 1223 (6th Cir. 1979), *rev'd on other grounds*, 449 U.S. 383 (1981); *see Diversified Industries, Inc. v. Meredith*, 572 F.2d 596 (8th Cir. 1977) (en banc).

Ignoring these clear lines of authority, and going beyond the spirit of the law as enunciated by this Court in *Powell*, the court below deemed the relevancy requirement of § 7602 satisfied if the requested documents "might throw light upon" the tax returns of the Petitioner. This very low threshold of proof is at variance with that required by other circuits.

These erroneous conclusions and the split in authority at the appellate level merit consideration of this case by the Supreme Court.

ARGUMENT

I. THE STANDARD OF RELEVANCE UNDER 26 U.S.C. § 7602 REQUIRES A FINAL DETERMINATION BY THIS COURT

Few in the corporate community or elsewhere would dispute the IRS' need for authority to examine the books, records, papers, etc., of a taxpayer in order to ascertain the correctness of a tax return. Indeed, such powers of examination in connection with an audit have been granted to the IRS under 26 U.S.C. § 7602. However, these broad investigatory powers are expressly limited to information that meets a threshold test of relevance. Thus, the statute itself empowers the IRS only to "examine any books, papers, records, or other data which *may be relevant* [to the examination of a tax return]." 26 U.S.C. § 7602 (emphasis supplied).

The determination of exactly what is relevant under this code provision requires a balancing of the IRS' need for records that will accurately reflect upon the correctness of a particular tax return against the right of a taxpayer to retain some degree of confidentiality and control over his files. Thus in *United States v. Powell*, 379 U.S. 48 (1964), this Court determined that an exercise of the summons power conferred upon the IRS by this section must comport with several factors, namely, "that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to [that] purpose, that the information sought is not already within the Commissioner's possession . . . ." 379 U.S. at 57-58. Although useful in delineating the boundaries of the relevance analysis and inquiry, *Powell* does little to define its content, particularly in a matter like the case at bar.

The records at issue here are those that comprise the Petitioner's "tax pool analysis." Simply stated, a tax pool analysis serves to identify issues on a company's tax return which its counsel believe might be questioned

or challenged by the IRS. It also speculates on the likelihood of IRS action on the return, and attempts to estimate and assign a total cost for these issues if they are settled or litigated. Here, this document was prepared at the direction of, and in consultation with, El Paso's in-house counsel and was not used in the preparation of the tax returns in question. Instead, the tax pool analysis was used for purposes completely unrelated to tax return preparation. More specifically, this analysis was generated in an effort to comply with good accounting practices and various requirements of the federal securities laws.

The SEC requires public corporations subject to its jurisdiction periodically to file audited financial statements. *See* 15 U.S.C. § 78*l*, 17 C.F.R. § 210 *et seq.* These statements must be prepared in accordance with "generally accepted accounting principles" which, in turn, require the disclosure of what are termed "material contingent liabilities." *See* American Institute of Certified Public Accountants, Statement on Auditing Standards No. 1, § 110.01 (1973). Since income tax liability is certainly important in determining the eventual net income of a corporation, additional tax assessments and the probability that they will be imposed are considered to be "material contingent liabilities" under these accepted accounting principles. Thus, certain of the elements contained in the tax pool analysis, prepared herein with the assistance of in-house counsel, were considered by the independent auditors in preparing the financial statements required by the SEC.

In rejecting the request of the IRS for the tax pool analysis on grounds of relevance, the Petitioner noted that the tax pool analysis was not used to prepare its tax returns. This fact was recognized by the lower court, since a tax pool analysis contains little more than private thoughts, theories, and speculations as regards the company's tax returns. ***United States v. The El Paso***

Company, 682 F.2d 530, 535 (5th Cir. 1982). For this and other reasons, a tax pool analysis was held not to be relevant to an IRS audit in *United States v. Coopers and Lybrand*, 550 F.2d 615 (10th Cir. 1977). The test that must be used in a relevance analysis, according to the court in *Coopers and Lybrand*, is a balancing test consisting of factors such as whether the information sought consisted of facts or opinions, whether it was prepared in connection with the tax return in question, whether the IRS could conduct the audit with the facts it had, and whether the IRS had demonstrated a specific need for the information sought rather than mere convenience. *Id.* at 621. *See also* Note, *A Balancing Approach to the Discoverability of Accountants' Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 Wash. U.L.Q. 185, 203 (1982). Buttressing this approach is the earlier decision of the Eighth Circuit in *United States v. Matras*, 487 F.2d 1271 (8th Cir. 1973), where the court held that only records of actual transactions were relevant to a determination of tax liability, *id.* at 1275; anything else was held not to be relevant under § 7602. Interestingly, the circuit court in *Matras* held that relevance must be construed to connote something more than mere convenience, rejecting a relevance standard based on a document's utility as a potential "road map" through a tax return. *Id.* This approach, rejected in *Matras*, was implicitly adopted by the court below. *See* 682 F.2d at 545.

A split among the circuits in this area developed in 1978 with the decision in *United States v. Noall*, 587 F.2d 123 (2d Cir. 1978), *cert. denied*, 441 U.S. 923 (1979) and widened in *United States v. Arthur Young and Co.*, 677 F.2d 211 (2d Cir. 1982), *petition for cert. filed*, No. 82-687 (Oct. 20, 1982). In these decisions, the reasoning of *Coopers and Lybrand* was rejected. In *Arthur Young*, the Second Circuit established a much lower threshold of relevance for determining the propriety of an IRS request for information under § 7602.

Spurning the balancing test of *Coopers and Lybrand*, the *Arthur Young* court declared that if the information sought "might have thrown light upon" the correctness of the return, the information requested would be deemed to be relevant under § 7602. *Arthur Young*, 677 F.2d at 218.[2]

In the proceedings below, the Fifth Circuit rejected the reasoning of *Coopers and Lybrand*, and by implication, *Matras*, and held that El Paso's tax pool analysis and related materials were relevant to an IRS audit of its 1976 through 1978 tax returns. The result is further confusion and conflict regarding the relevance standard: in the Fifth and Second Circuits, the tax pool analysis is deemed to be relevant and subject to production in a tax audit, while in the Tenth and Eighth Circuits it would not be.

The preparation of a tax pool analysis and its accompanying materials is widespread in American corporations; indeed, such an analysis is a necessary ingredient in the preparation of required financial statements. Corporations, while generally willing to allow reasonable access to documents that are germane to the preparation of their tax returns, contend that something more than an idle hope that a document will reveal a tax liability must be shown in order to compel its production. *See United States v. Coopers and Lybrand*, 413 F. Supp. 942, 949-54 (D. Colo. 1975). The Fifth Circuit, in rejecting the balancing test enunciated in *Coopers and Lybrand*, has given license to unlimited fishing expeditions through corporate files on the basis of little more than this "idle hope" that an examination of any document related to corporate finances—whether used in tax return preparation or not—will lead to a finding of additional tax liability. Under this "conveni-

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[2] Despite this, the Second Circuit also held that such information (in this case a tax pool analysis) was privileged, and therefore not discoverable under § 7602. 677 F.2d at 219.

ence" standard fashioned by the Fifth Circuit here, it is difficult to imagine any corporate document that the IRS could not deem relevant should it so desire. *See United States v. Matras*, 487 F.2d 1271, 1275 (8th Cir. 1973). It is doubtful that this was the intent of Congress in its passage of § 7602.

Finally, the decision of the court below here leads to the rather unfortunate result that separate independent operating entities of the same corporation could be subject to different standards of relevance for the production of records under the same statute, the Internal Revenue Code, depending upon the Circuit in which they happen to be located. The criteria for discovery under the tax laws should apply uniformly, just as its more substantive portions do. As such, this issue is worthy of review by this Court.

II. THE DECISION OF THE COURT OF APPEALS ERODES THE ATTORNEY-CLIENT PRIVILEGE

The attorney-client privilege is the oldest of the privileges recognized by law. The privilege is a fundamental principle in the relationship between the lawyer and client. Its purpose is to encourage full and frank communication in the hope that, in so doing, sound legal advice will be given and justice will be served. In the final draft of its proposed Model Rules of Professional Conduct, the American Bar Association has stated that the privilege "applies not merely to matters communicated in confidence by the client, but also to *all information relating to the representation*, whatever its source." *ABA Model Rules of Professional Conduct*, Rule 1.6. (Final Draft) (emphasis supplied).

The information sought by the IRS was prepared under the direction of, and in consultation with, the legal staff of El Paso and included its thoughts and opinions on the company's potential future tax liability, as well

as its opinion as to the probable outcome of litigation or negotiation based thereon. It should be emphasized that these matters consisted of opinions, not facts, and were not used by the Petitioner in the preparation of the tax returns that were the subject of the audit. The information at issue here was nothing more than speculation and opinion prepared to enable the Petitioner's tax advisers and in-house counsel to give sound advice on an issue of importance to the client.

Thusly characterized, the tax pool analysis would surely seem to be privileged information under the broad rubric of the attorney-client privilege. Indeed, even the Fifth Circuit below, while denying confidential treatment to those materials noted that the "purpose of the attorney-client privilege is to promote the flow of information to the attorney to enable him to give informed legal advice." *United States v. The El Paso Company*, 682 F.2d 530, 538 n.8 (5th Cir. 1982) (citing *Upjohn v. United States*, 449 U.S. 383 (1982)).

This is precisely one of the reasons that the tax pool analysis was done in the case at bar: to enable counsel to give his corporate client "informed legal advice" on the potential for future tax problems. Thus, by its own hand, the court below indicates that information of the type at issue here should be privileged. However, the Fifth Circuit deemed the privilege waived as to these documents since the Petitioner's counsel discussed some of the information regarding potential tax liability issues contained in the tax pool analysis with the independent auditors who certified the corporation's books pursuant to requirements of the SEC.

These discussions with the auditors were not optional or voluntary. Rather, a disclosure or discussion of certain of the issues contained in the tax pool analysis to independent auditors is necessary under the generally accepted standards of accounting mandated for corporate auditors who prepare the financial statements pur-

suant to the various federal securities laws. *E.g.*, 15 U.S.C. § 78*l*, 17 C.F.R. § 210 *et seq.* Such a disclosure would not be held to waive the attorney-client privilege as to the IRS under *Diversified Industries, Inc. v. Meredith*, 572 F.2d 596 (8th Cir. 1977) (en banc). Thus, this ruling not only conflicts with other authority, but results in a complete and involuntary waiver of the attorney-client privilege when a partial disclosure of otherwise privileged information is made to an accountant retained by the same client where such a disclosure is compelled by an effort to comply with federal law. This waiver occurs even if, as in this case, the rationale for the disclosure request under § 7602 is totally unrelated to that of the initial, partial communication of privileged information. Further, under the holding of the court below, the waiver extends not only to the disclosed information, but to the entire body of data from which the disclosed information was derived.

That this holding ignores and conflicts with other authority is reason enough for this Court to review the decision of the court below. Equally important, however, is the likelihood that the decision below, if allowed to stand, will do serious damage to other significant governmental goals. For example, a frequently acknowledged goal of the various federal securities laws is to foster public confidence in the securities markets. The principal means used to accomplish this aim is the required disclosure of all material facts regarding the health of a company. Of course, contingent liabilities are considered to be very much a part of the financial picture of any company. The likelihood of additional tax assessments is generally considered to be a "material contingent liability" of the sort that must be included in any SEC-mandated financial statement.

In the instant case, the Petitioner's counsel participated in the preparation of a report of these potential problems, and revealed certain items contained in this

tax pool analysis to the auditors. Significantly, the auditors did not receive any of the documents that made up the corpus of the analysis; they received only enough information to ensure compliance with SEC-mandated requirements for financial statements. Surely a company's own analysis of its tax situation and potential future tax liability is deserving of confidential treatment in such a situation, especially when the analysis has been prepared at the direction of its own legal staff as a means of estimating the likelihood of additional tax liability and future tax litigation or negotiation with the IRS. To permit, as the opinion of the court below does, the confidentiality of this information to be compromised based on what amounts to a necessary disclosure for purposes of compliance with other regualtory mandates can only lead to serious and unintended results. Corporate financial officers, aware that their discussions on tax issues with their own counsel may result in an unwitting loss of th privilege based on counsel's consultation with independent auditors, may well be very reluctant to give a full and accurate account of the company's tax situation to counsel. Counsel would then be left in the dark as to important factors, thereby rendering him incapable of giving reliable advice on this topic to his client. Similarly, should counsel possess such information, he or she will be reluctant to engage in even limited discussions with independent auditors for fear of triggering a complete waiver of the client's privilege. The end result could be less accurate financial statements, thereby undermining a central purpose of the securities laws.

The eventual outcome of this decision could well be less disclosure of a wide variety of salient facts to corporate counsel, the public, independent auditors, the SEC, and, eventually, the IRS. The holding of the court below must, as a result, be examined by this Court due to its potential impact on other laws and many companies throughout the economy.

CONCLUSION

In summary, the instant case presents this Court with an opportunity to resolve serious conflicts among the circuits in several important areas.

The standard of relevance under 26 U.S.C. § 7602 adopted by the court below is so broad as to make virtually any corporate document, whether tax-related or not, subject to the scrutiny of the IRS. This is not in keeping with precedents in other Circuits. Nor does it properly recognize this Court's efforts to delineate the bounds of the IRS' power to force disclosure of irrelevant information.

Secondly, the decision below seriously threatens to erode the attorney-client privilege, as enunciated by this Court in *Upjohn*. The privilege here has been lost due to the fact that some of the issues involved in the tax pool analysis were discussed with an independent auditor pursuant to efforts to comply with other federal laws. The fact that the court below has deemed the privilege lost as to these materials *in toto* even if the communication was confidential, essential for compliance with other laws, and where the materials were not related to the preparation of the questioned tax returns, makes this ruling so significant that it should have no further application without the specific approval of this Court.

This decision will be a source of confusion and uncertainty throughout the American business community. For these reasons, the Petition for the Writ of Certiorari should be granted.

Respectfully submitted,

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